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No. 811

# In the Supreme Court of the United States

OCTOBER TERM, 1958

MID-SOUTHERN FOUNDATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The opinion of the Tax Court (R. 90a–113a) is reported at 28 T.C. 918. The opinion of the court of appeals (Pet. 17–26) is reported at 262 F. 2d 134.

### JURISDICTION

The judgment of the court of appeals was entered on December 13, 1958 (Pet. 16). On March 14, 1959, the time for filing a petition for a writ of certiorari was extended to and including April 7, 1959. The petition was filed on April 3, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### QUESTION PRESENTED

Whether a reduction of assets below liabilities may be treated as a reduction of "equity capital" for

which an adjustment to the taxpayer's excess profits credit is required under §§ 435 (a) and (g) and 437(c) of the Internal Revenue Code of 1939.

## STATUTES INVOLVED

The pertinent parts of §§ 435 and 437 of the Internal Revenue Code of 1939 are set forth in the Appendix, *infra*, pp. 12–13.

## STATEMENT

The Commissioner determined deficiencies against the taxpayer for Korean War excess profits taxes in the amounts of $8,176.74 for 1950, $21,160.18 for 1951, and $404.99 for 1952 (for the short year January 1–June 10, 1952, the taxpayer having ceased to exist on the latter date).[1] The determinations were sustained by both the Tax Court (R. 90a–113a) and the court of appeals (Pet. 17–26).

The relevant facts were stipulated (R. 52a–59a). Taxpayer's normal tax net income and its excess profits tax net income for the several years were:[2]

| | 1950 | 1951 | 1952 |
|---|---|---|---|
| Normal tax net income (or loss) | $159,423.16 | $147,217.39 | ($301.96) |
| Excess profits tax net income | 175,896.79 | 179,963.67 | 12,415.53 |

[1] The taxpayer was the Madison Avenue Corporation, whose assets were taken over by petitioner on June 10, 1952 (R. 55a). Since petitioner's liability for Madison's taxes is conceded, no distinction is made between them.

[2] Numerous adjustments are made to normal tax net income in arriving at excess profits tax net income (§ 433(a)). The adjustment primarily responsible for the differences here is the partial disallowance, for excess profits tax purposes, of "interest on the indebtedness included in the daily amounts of borrowed capital" (§ 433(a)(1) (N) and (O)). All section references are to the Internal Revenue Code of 1939, as amended by the Excess Profits Tax Act of 1950, 64 Stat. 1137,

On June 7, 1950, taxpayer purchased for $1,500,000, and retired, 4,725 shares of its own stock. Taxpayer's total assets and liabilities (as determined for excess profits tax purposes), and the differences between them, at the beginning of each of the years were:

| | January 1 | | |
|---|---|---|---|
| | 1950 | 1951 | 1952 |
| Total assets | $1,360,950.19 | $1,377,115.65 | $981,092.56 |
| Total liabilities | 1,143,421.14 | 2,572,500.55 | 2,123,406.73 |
| Difference | 217,529.05 | (1,195,384.90) | (1,142,314.17) |

**ARGUMENT**

The issue presented here relates solely to the computation of the "excess profits credit" allowed taxpayer for 1951 and 1952.

1. The excess profits credit represents, in concept, the normal or fair income of the taxpayer, and the tax—designed to reach abnormal profits arising out of emergency conditions—is imposed only on the excess of the taxpayer's income over the credit. The credit is based initially on the taxpayer's average income in a presumably normal "base period" preceding the excess profits tax years, with an adjustment being made to reflect additions to capital made during the base period (§ 435(a)(1) (A) and (B)).[3] For calendar year taxpayers, as here, 1950 was the first taxable year and the base period was normally 1946–1949. As to such taxpayers, the result of the base-period computations (over which there is no dispute here) is, in effect, the starting excess profits

[3] An alternative method of computing the credit, based on invested capital (§ 436), is not involved here.

credit as of January 1, 1950—*i.e.*, as of beginning of the excess profits tax years.

To preserve the concept of the credit as a measure of fair or normal profits, it is necessary to make further adjustments to reflect capital changes during the taxable years (*i.e.*, after January 1, 1950), since changes in the capital invested in the business would presumably affect the profits quite apart from the abnormal conditions. The adjustments prescribed for that purpose take into account changes (in either equity or borrowed capital) up to the beginning of the taxable year (since January 1, 1950) and also changes occurring within the taxable year. The result of the computation is the "net capital addition" or "reduction" for the year, a figure which represents the difference between the average capital employed in the business during the taxable year and the capital employed as of January 1, 1950. The excess profits credit as of January 1, 1950, is then increased or decreased by 12% of the "addition" or "reduction" to arrive at the credit to be allowed for the taxable year (§ 435(a)(1)(C)).

The issue here concerns only one of the several items which go into the computation—the difference between the equity capital on the first day of the taxable year and the equity capital on January 1, 1950. As explained in the margin, the amount of that difference is ultimately reflected in full in the "net capital addition" or "reduction" for the year,[4] and

[4] The computations are "daily" in form. There is determined for each day of the taxable year the difference between the capital employed on that day and the capital employed on

the excess profits credit for the year is thus directly increased or decreased by 12% of that amount.

2. The precise issue is the determination, under §435(g)(4)(B), of:

> The amount, if any, by which the amount of the equity capital (as defined in section 437(c)) at the beginning of the taxpayer's first taxable year under this subchapter [January 1, 1950] exceeds the amount of the equity capital at the beginning of the taxable year.

Section 437(c) in relevant part provides:

> The equity capital of the taxpayer as of any

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January 1, 1950; the "daily" differences are then averaged to arrive at the "net capital addition" or "reduction" for the year (§435(g) (1) and (2)). In the case of borrowed capital, there is made a single direct comparison of each day to January 1, 1950 (§435(g) (3)(C) and (4)(C)). In the case of equity capital, however, the changes up to the beginning of the taxable year and the changes during the year are accounted for separately, so that there are two steps in computing the "daily" addition or reduction:

(1) the difference between the equity capital on the first day of the taxable year and the equity capital on January 1, 1950, is first determined (§435(g) (3)(B) and (4)(B)); and

(2) there is then added or subtracted to that difference the amount of the capital distributions to stockholders (or capital paid in) since the beginning of the year and before the day in question (§435(g) (3) (A) and (4)(A)).

The result is essentially the same as a direct comparison of each day's equity capital to the January 1, 1950, equity capital, except that current earnings and dividends are not taken into account. Since the first step of the daily equity capital computation is the same for each day of the taxable year, it is apparent that the amount determined in that step (the only item in issue here) will be reflected in full in the "net capital addition" or "reduction" arrived at by averaging the results of the daily computations.

> time shall be the total of its assets held at such time in good faith for the purposes of the business, reduced by the total of its liabilities at such time. * * *

The amounts of the taxpayer's assets and liabilities for the years in question are set forth in the Statement, *supra*, p. 3. On January 1, 1950, its assets exceeded its liabilities by some $217,000, and there is no dispute that that amount represents its equity capital on that date. On January 1, 1951, however (largely because of taxpayer's distribution of $1,500,000 to its stockholders in 1950), its assets were less than its liabilities by some $1,195,000. The question is what taxpayer's "equity capital" was on that date. The Commissioner contends that it was minus $1,195,000 and thus that equity capital on that date was $1,412,000 less than it was on January 1, 1950, for the purposes of § 435(g)(4)(B). Taxpayer, on the other hand, contends that "equity capital" as defined in § 437(c) can never be less than zero and thus that the reduction between the two dates was only $217,000.[5]

There is, we believe, no merit to taxpayer's contention. While it may be that in ordinary usage one does not think of a corporation having a negative equity capital, we are dealing here with a term of art statutorily defined to serve a particular purpose. Indeed, it is only because of the statutory definition, which requires the assets to be measured by their adjusted basis for tax purposes (§ 437(c)), that tax-

[5] Although the amounts vary slightly, the issue is identical for 1952.

payer, a fully solvent corporation, can be said to have greater liabilities than assets. The statutory definition, in turn, defines equity capital simply as the assets "reduced by" the liabilities, which carries no implication that the reduction is to stop at zero. To the contrary, when Congress, in another provision, imposed such a limitation, it expressly provided that an amount was to be "reduced (but not below zero) by" another amount (§ 435(f)(1); see Pet. 23).

The purpose of the computation, moreover, makes it essential that a reduction of equity capital below zero be taken into account. The computation is concerned not with the absolute amount of equity capital but only with *changes* of equity capital and the presumed effect such changes would have upon the taxpayer's income in normal circumstances. With liabilities remaining constant at $2,000,000, a reduction of assets from $2,000,000 to $1,000,000 would presumably have as much effect upon the taxpayer's normally-expected earnings as would a reduction from $3,000,000 to $2,000,000. Yet under petitioner's view no adjustment at all would be made to the excess profits credit in the former circumstance, although it would be reduced by $120,000 in the latter. Thus a fully solvent taxpayer whose assets on January 1, 1950, had a "basis" for tax purposes less than its liabilities could preserve its full excess profits credit throughout the excess profits tax years while making substantial capital distributions to stockholders and greatly reducing its investment in the business. That is essentially what taxpayer did here. Although its "equity capital" on January 1, 1950, was only

$217,000, taxpayer was able to distribute $1,500,000 to its stockholders in 1950 in redemption of stock. It now claims that only the first $217,000 of the distribution should affect its excess profits credit; the balance can be taken out of the business with no adjustment to the credit at all. That result, we submit, is contrary to the basic purpose of the statute to have the excess profits credit reflect changes in the capital employed in the business. The historical accident of a low tax "basis" for the assets, by which the "negative" equity capital is produced, is irrelevant, and the negative quantity must be taken into account in order to reflect the actual change in the capital employed in the taxpayer's business.

Taxpayer's contention produces another anomaly. The "equity capital" determination is used only to determine the capital change up to the beginning of the taxable year, and capital distributions during the taxable year are separately accounted for (see note 4, *supra*). Under § 435(g)(4)(A), the "net capital reduction" for the year (by 12% of which the excess profits credit is then reduced) includes "Distributions to shareholders * * * made during such taxable year which are not out of the earnings and profits of such taxable year." Since that provision contains no language by which it could be limited to distributions which do not reduce the assets below the liabilities,* it is clear that the full $1,500,000 distribution would have been in

* Taxpayer contended in the court of appeals that such a limitation should be inferred, but has abandoned the contention here.

part a capital reduction for 1950.[7] Taxpayer contends, however, that the capital reduction, fully taken into account for 1950, can be only partially taken into account (*i.e.*, up to $217,000) in the equity capital computation as of the beginning of 1951, with the anomalous result that its excess profits credit for 1951 would be *higher* than it was for 1950, although the taxpayer in fact had a relatively higher average investment in the business in 1950 than it did in 1951 (since the $1,500,000 was not distributed until the middle of 1950). There is no justification for such disparity between beginning-of-the-year equity capital determinations and mid-year adjustments. The purpose of the equity capital determination at the beginning of the year is simply to sum up, as a new starting point, the effect of the mid-year capital changes of the prior year, and the provisions governing the two determinations must be given consistent interpretations. Since capital distributions during the taxable year are fully reflected in the excess profits credit whether or not they reduce assets below liabilities, the equity capital reduction up to the beginning of the taxable year must likewise be fully taken into account whether or not it produces a "negative" equity capital.[8]

[7] The distribution was reflected only in the daily computations after its date (June 7, 1950), so that it would have produced a "net capital reduction" for the year (*i.e.*, after averaging the daily computations) only in the neighborhood of $800,000. See note 4, *supra*.

[8] Petitioner's objections to the imposition of an excess profits tax in a year (1952) when it had no normal tax net income (Pet. 2, 5–7) are frivolous. The relevant measure of income is the *excess profits tax* net income, which as noted above (p.

3. For the reasons explained in the margin, the Tax Court's decision in this case is not, as taxpayer asserts (Pet. 9-10), inconsistent with its earlier decision in *Thomas Paper Stock Co.* v. *Commissioner*, 22 T.C. 1294.* Even if it were, however, the instant

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2 and n. 2) may, and in this case did, vary considerably from normal tax net income. The anomaly, if any, arises from the differences in the definition of net income for the two purposes, and has nothing to do with the computation of the excess profits credit.

* *Thomas Paper* involved the adjustment to the excess profits credit, under entirely different substantive provisions, for capital additions *during the base period*. That adjustment was based on changes in the "yearly base period capital" during the base period years. Yearly base period capital was defined, in § 435(f)(1), as "the sum of the equity capital (as defined in § 437(c)) * * * and an amount equal to 75 per centum of the * * * borrowed capital * * *, reduced (but not below zero) by the sum of" various adjustments for inadmissible assets, etc. It was held that yearly base period capital could not be less than zero, even though a negative quantity was reached before the adjustments for inadmissible assets. Although the distinction was not always kept clear, the real basis for the decision was not that there could not be a negative "equity capital" under § 437(c), but only that there could not be a negative "yearly base period capital" under § 435(f)(1), a result reached by reading the "not below zero" limitation of the latter section as applying to the overall computation of yearly base period capital, whether a deficiency was produced before or after the adjustments for inadmissible assets. That distinction is clearly shown in the Commissioner's computation, which was affirmed by the Tax Court, in which a negative "equity capital" was actually determined and it was only the yearly base period capital that was limited to zero (compare lines 3 and 5 of the computation at 22 T.C., p. 1296). The Tax Court emphasized also that recognizing a negative yearly base period capital without recognizing also the further adjustments for inadmissible assets would produce distorted results when two years were compared, a problem not involved in the issue presented here.

decision, affirmed by the court of appeals and subsequently followed by the Tax Court (*Kentucky Farm & Cattle Co.* v. *Commissioner*, 30 T.C. 1355, 1368), would be controlling.

### CONCLUSION

The decision below is correct; there is no conflict; and the question, a narrow and highly technical one, is of no general importance. The Korean War excess profits tax terminated on December 31, 1953 (67 Stat. 175), and to date the issue has been raised only in this case and one other (*Kentucky Farm & Cattle Co., supra*). The petition for a writ of certiorari should be denied.

Respectfully submitted.

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## APPENDIX

Sections 435 and 437 of the Internal Revenue Code of 1939, as added by the Excess Profits Tax Act of 1950, 64 Stat. 1137, as amended (26 U.S.C., 1952 ed.), provide in part:

SEC. 435. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section, shall be—

(1) *Domestic Corporations.*—In the case of a domestic corporation the sum of—

(A) 83 per centum of the average base period net income,

(B) if the average base period net income of the taxpayer is the amount determined under subsection (d) of this section or under section 442, 12 per centum of the amount of the base period capital addition, computed under subsection (f), and

(C) 12 per centum of the net capital addition (as defined in subsection (g)(1)) for the taxable year,

minus 12 per centum of the net capital reduction (as defined in subsection (g)(2)) for the taxable year.

* * * * *

(g) *Net Capital Addition or Reduction.*—

* * * * *

(2) *Net Capital Reduction.*—The net capital reduction for the taxable year shall, for the purposes of this section, be the excess, divided by the number of days in the taxable year, of the aggregate of the daily capital reduction for each day of the taxable year over the

aggregate of the daily capital addition for each day of the taxable year. * * *

* * * * * *

(4) *Daily Capital Reduction.*—The daily capital reduction for any day of the taxable year shall, for the purposes of this section, be the sum of the following:

* * * * * *

(B) The amount, if any, by which the amount of the equity capital (as defined in section 437(c)) at the beginning of the taxpayer's first taxable year under this subchapter exceeds the amount of the equity capital at the beginning of the taxable year; and

* * * * * *

SEC. 437. * * * (c) *Definition of Equity Capital.*—The equity capital of the taxpayer as of any time shall be the total of its assets held at such time in good faith for the purposes of the business, reduced by the total of its liabilities at such time. For such purposes, the amount attributable to each asset shall be determined by ascertaining the adjusted basis thereof (or, in the case of money, the amount thereof) and the adjusted basis shall be the adjusted basis for determining gain upon sale or exchange. * * *

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